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Why sticky inflation will spur more rate hikes by RBI

Retail inflation, at 7.01 per cent in June, remains a concern as is the weakening rupee

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Inflation for the month of June, as expected, eased a bit to 7.01 per cent but remains much above the Reserve Bank of India (RBI) target inflation upper limit of 6 per cent. Inflation has breached the 6 per cent mark for six months in a row, starting January, and that continues to be worrying. This could lead to more rate hikes by the RBI in its upcoming review meeting in August. Some economists say it could even be as high as 50 basis points.

Consumer price inflation (CPI), or retail inflation, was 7.04 per cent in May and 7.8 per cent in April. The higher costs for cereals, vegetables and services in June were offset by the lower edible oil and fuel prices. Finance minister Nirmala Sitharaman has vowed to launch a "pointed attack" on inflation, which has threatened global economies since the start of Russia's Ukraine invasion in February. The rupee, meanwhile, is inching towards the 80 to a dollar mark. On July 13, the rupee sank to yet another record low and was trading at 79.62 to a dollar.

The marginal easing of inflation shows some impact of the rate hikes made twice by the RBI in the previous two months, as well as measures taken by the Centre, such as slashing of excise duties on fuel. Moreover, crude prices have started easing following global recession fears, and this is likely to take some pressure off oil prices. Brent crude prices fell below the $100 mark on July 12 and were trading around the $100 mark on July 13. Brent crude has lost over $20 in the past one month.

In early June, the RBI had raised the repo rate (the rate at which the central bank lends to commercial banks) by 50 basis points (half a percentage point) in order to control rising inflation. This took the repo rate to 4.90 per cent. In May, the RBI had hiked repo rates by 40 basis points, taking it to 4.40 per cent. Days after the RBI's rate hike move, the Centre announced a slew of measures on May 21 to curb inflation. This included a reduction in excise duty on petrol by Rs 8 a litre and on diesel by Rs 6 a litre. It would mean a revenue loss of Rs 1 lakh crore to the Centre. Further, a cut in customs duty on raw materials of plastics and steel, and an increase in export duty on iron ore and steel intermediaries were announced.

"The June inflation print shows that inflation based on CPI remains sticky above the RBI's target zone of 2-6 per cent. Even as food inflation moderated, fuel and core inflation rose during the month," says D.K. Joshi, chief economist with ratings firm Crisil. "For this fiscal, we expect CPI inflation to rise to 6.8 per cent average from 5.5 per cent last year, with the rise being broad-based. The outlook for food inflation remains grim after the heat wave's hit on production of key crops."

A normal and well-distributed monsoon is critical to secure adequate supplies of kharif crops, including rice. However, wheat supplies are expected to remain tight until the arrival of fresh rabi crop next year, adds Joshi. Elevated international commodity prices coupled with pending pass-through of cost pressures from the last fiscal will continue to put pressure on food, fuel and core inflation, he said.

Other experts too say that a healthy monsoon and kharif sowing will be crucial for containing food inflation. However, elevated global crude oil prices and weakening of the rupee against the dollar pose a threat to the near-term inflation outlook. “We expect consumer inflation to track back within the RBI’s target range only in the fourth quarter of the current fiscal,” says Rajani Sinha, chief economist, CareEdge Group. She projects inflation to average at 6.6 per cent for the entire financial year. “The RBI’s policy action will be contingent on volatility in global crude oil prices and the rate hike trajectory by the US Fed. We see a 50 bps rate hike in August policy followed by incremental hikes of 25 bps each in the next two meetings (till December) with terminal repo rate at 5.90 per cent,” adds Sinha.